Internal Revenue Service

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Department of the Treasury

Washington D.C. 20224

Person to Contact

Telephone Number:

Refer Reply To:
CC:DOM:FI&P:4 - PLR 109055-99
Date: SEPTEMBER 14, 1999

In re:

Legend:

Taxpayer	=
Date 1	=
Date 2	=
Date 3	=
a	=
State	=
b	=
c	=
d	=
Policy A	=
Policy B	=
Policy C	=

Policy D =

Date 4 =

e =

f =

g =

h =

i =

Systems Company =

Year 1 =

Month 1 =

Month 2 =

Year 2 =

l firm =

j =

Dear

This is in response to your Date 1 letter, and your Dates 2 and 3 supplemental submissions, requesting a ruling that the noncompliance of certain of Taxpayer's policies with the requirements of § 7702 be waived pursuant to § 7702(f)(8). This ruling applies to the a contracts listed in Exhibit A.

FACTS

Taxpayer is a stock life insurance company organized and operated under the laws of State. It is licensed to engage in the life insurance business in b states, and in c.

This request for waiver relates to d types of flexible premium universal life insurance contracts Taxpayer issues, Policies A, B, C and D (Policies). All of the Policies which are the subject of this request are considered life insurance contracts under the laws of the states or other jurisdictions in which they were issued; were issued after December 31, 1984, the effective date of § 7702; and, were intended to comply with that section by satisfying both the "guideline premium requirements" of § 7702(a)(2)(A) and (c), and falling within the "cash value corridor" prescribed in § 7702(a)(2)(B) and (d). As of Date 4, Taxpayer had approximately e policies in force including f Policy A contracts, g Policy B contracts, h Policy C contracts and i Policy D contracts.

All of the Policies provide for the payment of an initial premium and planned periodic premiums. Policyholders are permitted to change the frequency, as well as increase or decrease the amount, of the planned periodic premiums. They also are permitted to make unscheduled premium payments at any time prior to the maturity of their policies. Taxpayer reserves the right to limit premium payments.

For each policy issued, Taxpayer computed a "Premium Limitation" equal to the guideline premium limitation prescribed in § 7702(c)(2). After calculating that limitation, Taxpayer (as described below) monitored the premium payments in order to prevent a Policy's premiums from exceeding it, thereby causing the Policy to fail to qualify as a life insurance contract for federal income tax purposes. (Premium payments in excess of that limitation are referred to in this letter as Excess Premiums.)

In Year 1, Taxpayer acquired from Systems Company, a computer-based monitoring system (the monitoring system, or system) designed to administer numerous aspects of its life insurance contracts, including their compliance with the requirements of § 7702. Those requirements included the guideline premium requirements under § 7702(c), the cash value corridor requirements under § 7702(d), the computational rules under § 7702(e) and the definitions and special rules under § 7702(f). It utilized the system, and accompanying manual procedures, to ensure it complied with those requirements.

The monitoring system generates a daily report listing the life insurance contracts with respect to which the system identifies an error in contract administration, together with a corresponding error message briefly describing the error(s) involved on each contract (the daily error report). Each daily error report lists those life insurance contracts for which an error has been identified since the system generated the previous error report. Each day when a daily error report is generated, it is distributed to Taxpayer representatives responsible for addressing the errors identified in it.

At the end of each week, an individual in Taxpayer's Premium Accounting Department manually compiles the information on the daily error reports for the week and generates a weekly report (the weekly error report). The weekly error report lists every life insurance contract with respect to which the system has identified an error in contract administration, the corresponding error message(s) for each contract, and Taxpayer's department responsible for correcting each error. The weekly error reports are distributed to Taxpayer representatives responsible for addressing the errors identified in it. A life insurance contract listed on the weekly error report will continue to appear on that report's listings until all the errors identified with respect to that contact are addressed.

Premiums paid under the Policies are processed by different departments of Taxpayer, depending on the circumstances under which the premiums are paid. The initial premium paid under a newly issued Policy is processed by a customer service representative in Taxpayer's New Business Department responsible for processing the issuance of the Policy. Subsequent premiums paid under the Policy, other than those paid under the "lock box" method of paying premiums (described below), usually are processed by a customer service representative in the Premium Accounting Department, unless the premium is paid in connection with a change to the Policy. If a policyholder makes a change to his or her Policy, the premium (if any) paid in connection with the change is processed by a customer service representative in the Policyholder Service Department responsible for processing the change. Premiums (other than those paid under the lock box method) paid after such a change are processed by a customer service representative in the Premium Accounting Department.

With respect to the requirements of § 7702, the monitoring system calculates and monitors the Premium Limitation applicable to each of the Policies. The system compares the premiums paid under each Policy with the Premium Limitation for the Policy when it is issued, when a premium is paid, and again, at the time of a change to a policy which affects the Premium Limitation.

There are four methods by which premium payments may be made under the Policies, (1) the "pre-authorized check" method, (2) the "manual processing" method, (3) the "batch processing" method, and (4) the "lock box" method.

Under the pre-authorized check method, the monitoring system accepts only checks for premiums of pre-approved amounts. The pre-approved amount at any time is less than or equal to the excess of (1) the Policy's Premium limitation at that time, over (2) the sum of the premiums paid under the Policy at that time. If the amount of a pre-authorized check for a Policy, together with the sum of the premiums previously paid under the Policy, exceeds the Premium Limitation for the Policy, the system automatically generates a warning message on the daily error report and rejects the premium. The warning message can not be overridden by a customer service representative to force the system to accept the premium. Taxpayer's procedures require that a check for a premium in excess of the pre-approved amount be returned immediately to the policyholder.

Under the manual processing method, premium payments under a Policy are processed manually by a customer service representative in the department responsible for processing the premiums. If a customer service representative attempts to process an Excess Premium, the monitoring system automatically generates a warning message indicating that the Premium Limitation will be exceeded if the payment is processed. When such a message is produced, Taxpayer's procedures require that the premium payment not be accepted. Rather the premium is to be returned immediately to the policyholder. Hence, if these procedures are followed, no Excess Premium can be accepted and credited under a Policy.

In Year 2, Taxpayer implemented a batch processing method of processing certain premiums. Under that method, each business day, premiums received by Taxpayer are delivered to customer service representatives responsible for processing premium payments. Each premium under a policy is processed, regardless of whether it would result in the sum of the premiums paid under the Policy exceeding the Policy's Premium Limitation. If the premium is an Excess Premium, the monitoring system automatically identifies the Policy on the next daily error report, together with an error message indicating that the premium paid exceeds the Premium Limitation. Taxpayer's procedures require that the premium be returned immediately (i.e., the next day) to the policyholder. Hence, under the batch processing method, if Taxpayer's procedures are followed, no Excess Premiums can be accepted and credited under a Policy.

Also in Year 2, Taxpayer implemented a lock box method of processing certain premium payments. Under this method, premiums billed to policyholders were received at a bank lock box. At the end of each day, bank personnel enter into the bank's computer system the information about each premium received that day, including the amount of the premium and the policy number of the Policy under which the premium is paid. The bank then transmits this information to Systems Company, which, in turn is responsible for processing all the premium payments the same evening.

As with the batch processing method, each premium under a Policy is processed under the lock box method, regardless of whether it would result in the sum of the premiums paid under the Policy exceeding the Policy's Premium Limitation. If the premium is an Excess Premium, the monitoring system automatically identifies the Policy on the next daily error report, together with an error message indicating that the premium paid exceeds the Premium Limitation. Taxpayer's procedures require that the premium be returned immediately (i.e., the next day) to the policyholder. Hence, under the lock box method, no Excess Premium can be accepted and credited under a Policy, if these procedures are followed.

In Month 1, Taxpayer took the extra precaution of adding an automatic suspension feature in its monitoring system. Under that procedure, as in effect prior to its modification (discussed below) in Month 2, if an Excess Premium remained in a Policy for more than 60 days after the end of the policy year in which the payment was made, the system automatically suspended the Policy. Also, the Policy was identified as suspended on the weekly error report. Under the automatic suspension feature, as in effect from Month 1 to Month 2, if such an Excess Premium was not refunded with interest within 60 days after the end of the policy year in which the excess premium was made, all processing with respect to the Policy, e.g., the issuing of policyholder billing notices and the processing of premium payments, requests for loans and partial withdrawals, and changes to the Policy, was discontinued.

Taxpayer realized that by accelerating the suspension of a Policy to the end of the policy year in which an Excess Premium was paid (rather than 60 days after the end of the policy year), it would give itself an additional opportunity to return the Excess Premium (with interest) to the policyholder within 60 days of the end of the policy year in accordance with § 7702(f)(1)(B). Accordingly, in Month 2, Taxpayer modified the automatic suspension feature. Under that feature, as modified, if an Excess Premium under a Policy is not refunded (with interest) by the end of the policy year in which it is paid, the system automatically suspends the Policy at the end of the Policy Year (rather than 60 days after the end of that year). In addition, at that time Taxpayer established additional manual procedures requiring customer service representatives to (1) identify a suspended Policy that was listed on the weekly error report, and (2) return the Excess Premium payments under a suspended Policy, with interest, to the policyholder within 60 days of the end of the policy year.

The compliance failures of all of the Failed Policies occurred prior to the modification of the suspension feature, and the addition of the accompanying manual procedures, in Month 2. Taxpayer is aware of the occurrence of no compliance failure with respect to a Policy since Month 2.[1]

After one of its customer service representative's identified a Policy that she suspected was a Failed Policy, Taxpayer utilized its own personnel as well as personnel from its outside auditor and l firm to conduct a review of its Policies and to identify any Failed Policies that might exist. As a result of that review, Taxpayer discovered that it processed and accepted premiums paid with respect to a Policies, including j terminated policies, in excess of the respective Premium limitations for those Policies, and that such Excess Premiums were not returned (with interest) within 60 days after the end of the policy year in which they were accepted.

Specifically, in some instances customer service representatives inadvertently processed Excess Premium payments under the manual processing method notwithstanding the warning message generated by the monitoring system at the time the payments were processed and contrary to Taxpayer's procedures requiring the rejection of such payments and their immediate return to the policyholders. Further, in

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[1]Taxpayer estimates that approximately once per business day, Policyholders attempt to pay premiums in excess of the guideline premiums (excess premiums) under their policies, and that they did so at roughly that rate at the time the a policies with respect to which this waiver is being sought (the Failed Policies), failed to comply with the requirements of § 7702. Thus, Taxpayer believes that, over the years, there have been several thousand instances in which policyholders have attempted to pay Excess Premiums, but in only a instances, did Taxpayer fail to identify and return those Excess Premiums.

some instances under the batch processing and lock box methods adopted by Taxpayer in Year 2, customer service representatives erroneously failed to return Excess Premiums to the policyholders immediately, notwithstanding the identification of the Policies on the daily error report and contrary to Taxpayer's procedures requiring the immediate return of the Excess Premiums. Taxpayer represents that its non-compliance with the requirements of § 7702 was unintentional, and the failures described above on the part of the customer service representatives are the only errors that resulted in the non-compliance of the Failed Policies with the requirements of § 7702.

In addition to instituting and modifying the automatic suspension feature designed to remedy the failure of any Policy, Taxpayer is developing a modification to its monitoring system which would prevent the crediting of Excess Premiums under its Policies. The modification would provide that if a policyholder attempts to pay an Excess Premium under a Policy, the monitoring system would automatically reject the Excess Premium payment. Accordingly, under the modified monitoring system, Excess Premiums could no longer be credited under a Policy, and thus the errors resulting in the compliance failures of the Failed Policies could no longer occur. Taxpayer has been testing this modification, and hopes to implement it, and any accompanying manual procedures, within the next few months.

Taxpayer proposes to remedy the compliance failures of each Failed Policy which is in force on the date of the execution of the waiver and under which the sum of the premiums paid as of that date exceeds the relevant Policy's Premium Limitation as of that date. It proposes to do so by (1) increasing the death benefits payable under that Policy or (2) refunding to the policyholder the excess premiums paid under the failed Policy (with interest) less any excess premiums (and interest) previously refunded. Taxpayer is prepared to implement these corrective measures within 90 days from the effective date of the waiver. Taxpayer represents that following the implementation of the corrective measures, the Failed Policies will satisfy the requirements of § 7702.

RULING REQUESTED

Taxpayer requests the Service to waive the failure of the Failed Policies to satisfy the requirements of § 7702.

LAW

Section 7702 of the Code defines the term "life insurance contract" for all purposes of the Code. Under § 7702(a), in order to be considered a life insurance contract for federal tax purposes, a contract must qualify as such under applicable law and must satisfy either the "cash value accumulation test" set out in § 7702(a)(1) and (b), or meet the § 7702(a)(2)(A) and (c) "guideline premium requirements", and fall within the § 7702(a)(2)(B) and (d) "cash value corridor".

Section 7702(f)(1)(B) provides that if in order to comply with the guideline premium requirements, any portion of the premium paid during any contract year is returned by the insurance company (with interest) within 60 days of the end of the contract year, then the amount so returned (excluding interest) will be deemed to reduce the sum of the premiums paid under the contract during such year.

Section 7702(f)(8) provides that the Secretary of the Treasury may waive a failure to satisfy the requirements of § 7702 if the taxpayer establishes to the satisfaction of the Secretary that the failure was due to "reasonable error" and that "reasonable steps are being taken to remedy the error."

After considering all of the facts and circumstances, we find that the failure of the a policies to satisfy the requirements of § 7702(a) was due to reasonable error, and Taxpayer is taking reasonable steps to remedy the error.

CONCLUSION

Taxpayer is granted a waiver under § 7702(f)(8) for the failure of the Policies listed in Exhibit A to satisfy the requirements of § 7702.

The rulings in this letter are based on the information and representations Taxpayer submitted under penalties of perjury. While this office has not verified any of the material submitted in support of the request for the ruling, it is subject to verification on examination.

No opinion is expressed as to whether the a Policies comply with those requirements of § 7702 (or of any other sections of the Code and of the income tax regulations) that were not the subject of this letter ruling.

This ruling is directed only to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore this ruling will be modified or revoked by the adoption of temporary or final regulations to the extent that the regulations are inconsistent with any conclusion in the ruling. <u>See</u> section 12.04 of Rev. Proc. 99-1, 1999-1 I.R.B. 6, 47. However, when the criteria in section 12.05 of Rev. Proc. 99-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

A copy of this ruling must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Taxpayer.

Sincerely,

Assistant Chief Counsel
(Financial Institutions
& Products)

By: /S/____________________
Mark S. Smith
Chief, Branch 4